

## Message Text

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ACTION EUR-12

INFO OCT-01 EA-10 IO-13 ISO-00 EURE-00 SP-02 USIA-06  
AID-05 EB-08 NSC-05 SS-15 STR-04 OMB-01 CEA-01  
CIAE-00 FRB-03 INR-07 NSAE-00 XMB-02 OPIC-03  
LAB-04 SIL-01 L-03 H-01 PA-01 PRS-01 STRE-00  
/109 W

-----113994 301543Z /43

P R 301439Z AUG 77  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC PRIORITY 7775  
INFO TREASURY DEPT WASHDC PRIORITY  
AMEMBASSY ANKARA  
AMEMBASSY ATHENS  
AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY COPENHAGEN  
AMEMBASSY LISBON  
AMEMBASSY LUXEMBOURG  
AMEMBASSY OSLO  
AMEMBASSY OTTAWA  
AMEMBASSY PARIS  
AMEMBASSY ROME  
AMEMBASSY REYKJAVIK  
AMEMBASSY THE HAGUE  
AMEMBASSY TOKYO  
AMCONSUL BELFAST  
AMCONSUL EDINBURGH  
USMISSION GENEVA  
USDOC WASHDC

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DEPT PASS FEDERAL RESERVE BOARD

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USOECDC ALSO FOR EMBASSY  
USMTN

E.O. 11652: N/A  
TAGS: EGEN, UK  
SUBJECT: BRITISH ECONOMY: THE BEST OF TIMES, THE  
WORST OF TIMES?

REF: (A) LONDON 12122; (B) LONDON 12463; (C) LONDON  
12704; (D) LONDON 12777; (E) LONDON 14167;  
(F) LONDON 14174; (G) LONDON 14175

1. SUMMARY. IN THE YEAR AHEAD, THE UK WILL PASS THROUG  
CRITICAL POINTS FOR REASSESSMENT, AND POSSIBLY RE-  
VISION, OF BASIC BRITISH ECONOMIC STRATEGY. THE AUTUMN  
MONTHS WILL BE SPRINKLED WITH DECISION-PROVOKING EVENTS,  
STARTING WITH THE TRADE UNION CONGRESS CONVENTION OF  
SEPTEMBER 5-9 AND RUNNING THROUGH THE NOVEMBER VISIT OF  
AN IMF TEAM TO DISCUSS FUTURE BRITISH DRAWINGS AND  
BRITISH ECONOMIC POLICIES. BUT THE LIMITED ECONOMIC  
LEEWAY THE GOVERNMENT IS LIKELY TO HAVE, TOGETHER WITH  
POLITICAL CONSIDERATIONS, WILL PROBABLY WORK TO POSTPONE  
ANY FAR-REACHING REVISION OF POLICIES UNTIL THE SPRING  
BUDGET.

2. ECONOMIC TRENDS HAVE CAPTURED MOST BRITISH PRESS  
ATTENTION IN A MONTH WHEN LITTLE ELSE HAS GRIPPED THE  
DOMESTIC SCENE. CONTINUED BUILDUP OF RESERVES AND THE  
NEW STRENGTH OF THE POUND HAVE BEEN COUPLED IN ANALYSES  
WITH THE PROSPECTS OF FUTURE NORTH SEA REVENUES AND THE  
RESULT HAS BEEN A SPATE OF DISCUSSIONS OF THE LONGER TER  
USES OF BRITAIN'S OIL REVENUES AND ALSO OF THE IMPLI-  
CATIONS THESE ARE SUPPOSED TO HAVE FOR THE SHORT - AND  
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MEDIUM - TERM MANAGEMENT OF THE BRITISH ECONOMY. THESE  
FAVORABLE EXTERNAL DEVELOPMENTS AND PROSPECTS HAVE, HOW-  
EVER, CONTRASTED WITH A RAGGED SERIES OF SKIRMISHES BE-  
TWEEN THE GOVERNMENT, VARIOUS UNIONS AND EMPLOYERS OVER  
WAGE CLAIMS AND SETTLEMENTS WHICH VIOLATE THE GOVERN-  
MENT'S NOTION OF A PROPER INCOMES POLICY TO PREVENT  
ANOTHER WAGE EXPLOSION. THIS SLOW UNRAVELLING OF THE  
LABOR PEACE OF THE LAST TWO YEARS IS CONNECTED OF COURSE  
WITH THE WIDENING OF THE GAP BETWEEN PRICES AND AVERAGE  
EARNINGS THAT BEGAN TO OPEN IN MID-1976.

3. THE TWO SETS OF DEVELOPMENTS ALSO ARE LINKED IN  
RISING SPECULATION ABOUT A NEW GOVERNMENT STIMULUS TO  
THE ECONOMY, THROUGH INCREASED SPENDING OR REDUCED TAXA-  
TION --A STIMULUS WHICH SOME ARGUE HAS BEEN MADE POSSIBL  
BY THE IMPROVEMENT IN THE UK'S EXTERNAL POSITION AND  
COROLLARY LACK OF FURTHER NEED FOR FINANCIAL ASSISTANCE  
FROM THE IMF (WHICH IN LABOR PARTY AND TUC MYTHOLOGY  
PLAYS THE ROLE OF STRICT NANNY IN THE ECONOMIC NURSERY).  
THE OBJECT, IN THE VIEW OF THOSE FAVORING REFLATION,  
WOULD BE TO TAKE UP THE SLACK IN THE ECONOMY AND REDUCE  
THE UNEMPLOYMENT RATE; OR, MORE CYNICALLY, TO ACCOMMO-

DATE THROUGH AN INCREASE IN THE MONEY SUPPLY, RATHER  
THAN BY INCREASED UNEMPLOYMENT, A LARGE INCREASE IN  
WAGES THAT MAY BE DELAYED AND CONSTRAINED BY GOVERNMENT  
RESISTANCE BUT NOT TOTALLY AVOIDED. END SUMMARY

4. INTRODUCTION. REFTELS A-D REMAIN VALID AS DESCRIPTIONS OF THE BRITISH ECONOMIC SITUATION AND ITS POLITICAL RAMIFICATIONS; REFTELS E-G REPORT ON RECENT DEVELOPMENTS. THIS MESSAGE AIMS TO BRING TOGETHER THE

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LAB-04 SIL-01 L-03 H-01 PA-01 PRS-01 STRE-00  
/109 W

-----114051 301543Z /50

P R 301439Z AUG 77  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC PRIORITY 7776  
INFO TREASURY DEPT WASHDC PRIORITY  
AMEMBASSY ANKARA  
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AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY COPENHAGEN  
AMEMBASSY LISBON  
AMEMBASSY LUXEMBOURG  
AMEMBASSY OSLO  
AMEMBASSY OTTAWA  
AMEMBASSY PARIS  
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AMEMBASSY REYKJAVIK  
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VARIOUS ELEMENTS IN THE EARLIER SERIES OF MESSAGES, BUT  
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ITS MAIN PURPOSE IS TO SKETCH THE PICTURE AS IT APPEARS  
AFTER THE SUMMER HOLIDAYS.

5. BRIGHTENING INTERNATIONAL PAYMENTS POSITION. CON-  
SIDERABLE ATTENTION HAS BEEN GIVEN TO PUBLICATION OF TWO  
SETS OF STATISTICS; IN EARLY AUGUST THE BANK OF ENGLAND  
REPORTED THAT RESERVES HAD RISEN BY \$1.8 BILLION TO A  
NEW RECORD LEVEL OF \$13.4 BILLION. JUST PRIOR TO THIS  
ANNOUNCEMENT THE BANK HAD ALLOWED THE POUND TO MOVE UP  
FROM THE \$1.72 LEVEL MAINTAINED FOR MANY MONTHS TO \$1.74  
IN ORDER TO RESTORE THE TRADE-WEIGHTED INDEX WHICH HAD  
DECLINED WITH THE POUND LINKED TO THE DOLLAR AT \$1.72.  
IN SUBSEQUENT WEEKS THE TRADE-WEIGHTED INDEX HAS CON-  
TINUED TO EXHIBIT STABILITY AND RESERVES HAVE FURTHER  
INCREASED.

6. ON AUGUST 10, THE TREASURY PUBLISHED ITS FIRST COM-  
PREHENSIVE FORECASTS SINCE JULY 1976 OF NORTH SEA OIL  
REVENUES AND THEIR BALANCE OF PAYMENTS EFFECTS. WHILE  
THESE DATA DID NOT CHANGE THE EARLIER PICTURE RADICALLY-  
INDEED THEY SUGGESTED A SOMEWHAT LOWER LEVEL OF REVENUES  
AND BALANCE OF PAYMENTS GAINS DURING THE MID-1980'S THAN  
THE EARLIER FORECASTS - THEY AWAKENED AN APPARENTLY VERY  
STRONG LATENT INTEREST AND PROVOKED A NUMBER OF ARTICLES

7. THE TREASURY FORECASTS INDICATE THAT THE CONTRIBU-  
TIONS OF NORTH SEA OIL TO THE GOVERNMENT TAX REVENUES  
BECOME SIGNIFICANT ONLY SOME YEARS FROM NOW. EVEN THE  
BALANCE OF PAYMENTS EFFECT, WHILE IT ALREADY IS SUB-  
STANTIAL, IS DUE TO GROW TO 3-4 TIMES ITS CURRENT MAGNI-  
TUDE IN THE 1980'S.

8. DESPITE THIS, SOME OF THE UNOFFICIAL ANALYSES THAT  
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HAVE BEEN PUBLISHED SHOW A TENDENCY TO READ FUTURE NORTH  
SEA PROSPECTS INTO THE PRESENT SITUATION. SOME ANALYSTS  
- E.G., THE NATIONAL INSTITUTE IN ITS LATEST REVIEW -  
SUGGEST THAT THE BALANCE OF PAYMENTS IS NO LONGER TO BE

REGARDED AS A PINCHING CONSTRAINT; BRITAIN NOT ONLY HAS AN ABUNDANT RESERVE POSITION BUT HAS THE PROSPECTS OF CONTINUED IMPROVEMENT IN ITS BALANCE OF PAYMENTS DUE TO GROWTH IN OIL PRODUCTION, PROVIDE EXPANSIONARY POLICIES DO NOT OFFSET THE BENEFIT. THESE ANALYSTS ARGUE THAT BRITAIN DOES NOT NOW AND WILL NOT IN THE FORESEEABLE FUTURE NEED MORE IMF LOANS. AS COROLLARY, BY REPAYING ITS IMF DEBT IT COULD RELEASE ITSELF FROM ITS IMF OBLIGATIONS TO LIMIT THE PUBLIC SECTOR BORROWING REQUIREMENT AND THE GROWTH IN DOMESTIC CREDIT EXPANSION.

9. PRESSURES FOR CHANGES IN GOVERNMENT POLICIES. THE LEEWAY TO REMOVE MONETARY AND FISCAL RESTRAINTS THAT SEEMS TO BE CREATED BY PRESENT AND PROSPECTIVE BRIGHTENING OF THE EXTERNAL PAYMENTS SITUATION MAY BE NEEDED, IT IS ARGUED, IF THE POLICY OF WAGE RESTRAINT FAILS. SINCE STAGE II ENDED JULY 31, THE GOVERNMENT HAS FOUGHT A SERIES OF SKIRMISHES, ATTEMPTING TO PUT BACKBONE INTO FIRMS FACING DEMANDS FROM UNIONS THAT WOULD VIOLATE EITHER THE TWELVE MONTH RULE OR THE 10 PERCENT NORM FOR EARNINGS INCREASES (REF F). FOR EXAMPLE, IN TWO EARLY CASES (ONE INVOLVING THE AMERICAN FIRM HEINZ), THE GOVERNMENT PRESSURED THE FIRMS INTO RECONSIDERING DEALS THEY HAD STRUCK. IN ANOTHER CASE THE GOVERNMENT HAS DEPRIVED A FIRM OF EXPORT CREDIT GUARANTY DEPARTMENT ASSISTANCE. THREE SMALL FIRMS HAVE BEEN PLACED ON A BLACKLIST DENYING THEM GOVERNMENT CONTRACTS AND IN THE FIRST SIGNIFICANT CHALLENGE IN THE PUBLIC SECTOR THE GOVERNMENT HAS ADAMANTLY REJECTED THE CLAIMS OF THE AIR TRAFFIC CONTROLLERS ASSISTANTS (LONDON 14174). IN THE WINGS ARE A NUMBER OF OTHER NEGOTIATIONS (SOME INVOLVING AMERICAN FIRMS - SUCH AS FORD, KODAK AND CHRYSLER).  
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10. THE GOVERNMENT AS YET HAS NO ASSURED ALLIES. THE BALANCE OF VOTES IN THE TUC BETWEEN ENDORSEMENT AND REJECTION OF THE TWELVE MONTH RULE APPEARS NARROW, AND CALLAGHAN'S DECISION TO ATTEND THE TUC CONVENTION TO SECURE ENDORSEMENT MAY NOT TIP THE SCALE. THE CBI HAS FOLLOWED A TORTUOUS COURSE IN ITS ATTITUDE ON INCOMES POLICIES BUT SEEMS TO BE COMING OUT PRETTY LOUD AND CLEAR AGAINST THE GOVERNMENT'S PENALIZING FIRMS BY DEPRIVING THEM OF ECGD ASSISTANCE OR GOVERNMENT CONTRACTS FOR VIOLATING THE GOVERNMENT'S POLICY.

11. THE SITUATION HAS NOT BEEN AIDED BY THE PUBLICATION OF SOME OTHER, LESS ROSY, STATISTICS ON THE STATE OF THE

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ACTION EUR-12

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LAB-04 SIL-01 L-03 H-01 PA-01 PRS-01 STRE-00  
/109 W

-----114129 301544Z /45

P R 301439Z AUG 77  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC PRIORITY 7777  
INFO TREASURY DEPT WASHDC PRIORITY  
AMEMBASSY ANKARA  
AMEMBASSY ATHENS  
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AMEMBASSY BRUSSELS  
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DOMESTIC ECONOMY. THEY INDICATE THAT WHILE THE RATE OF  
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PRICE INCREASE HAS BEEN GOING DOWN, IT'S STILL RUNNING WELL AHEAD OF EARNINGS GROWTH, SO THAT AVERAGE REAL EARNINGS -- PRE-TAX -- HAVE DROPPED BY ABOUT EIGHT PERCENT SINCE LAST SUMMER WHEN THESE TRENDS STARTED TO DIVERGE. UNEMPLOYMENT HAS CONTINUED TO GROW, REACHING SIX PERCENT FOR ADULT WORKERS IN THE UK (REF G). WITH INDUSTRIAL PRODUCTION STILL LOWER THAN IT WAS IN 1973 AND WITH OVERALL GDP SHOWING LITTLE GROWTH OVER 1976, THE PROSPECTS ARE FOR GROWTH, NOT DIMINUTION, IN UNEMPLOYMENT.

12. THIS PROSPECT - OF GROWTH CONTINUING TO BE VERY SLUGGISH FOR THE REMAINDER OF 1977 AND THE POOL OF IDLE WORKERS CONTINUING TO INCREASE - WILL BE THE BACKDROP WHEN THE GOVERNMENT FACES ITS SUPPORTERS AT THE TUC CONVENTION IN SEPTEMBER, AND AT THE LABOR PARTY CONFERENCE ON OCTOBER 3-7, AND IS CERTAIN TO PRODUCE VOCAL DEMANDS FOR REFLATIONARY ACTION. THIS SITUATION WILL BE SEIZED ON BY THE CONSERVATIVES WHEN THEY MEET OCTOBER 11-14 AND WHEN THE POLITICAL VACATION ENDS, WITH THE RECONVENING OF PARLIAMENT, IT WILL NO DOUBT RECEIVE FURTHER ATTENTION IN THE FORM OF PRESSURE TO REFLATE.

13. BUT THE GOVERNMENT HAS ANOTHER SERIES OF DATES TO CONSIDER. EARLY IN NOVEMBER THE IMF WILL BE SENDING A TEAM TO DISCUSS WHAT THE BRITISH INTEND BY WAY OF FURTHER IMF DRAWINGS AND WHAT THEY SEE AS PROSPECTS FOR THE BRITISH ECONOMY. BY NOVEMBER THE GOVERNMENT WILL IN ALL LIKELIHOOD MAKE A DECISION AS TO WHETHER TO TAKE THE NEXT DRAWING FROM THE IMF SCHEDULED FOR NOVEMBER 25.

14. WE BELIEVE THAT WHILE THE GOVERNMENT WILL HAVE A DIFFICULT TIME RESISTING THE PRESSURES FOR A RELAXATION LIMITED OFFICIAL USE

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OF ITS FISCAL AND MONETARY POLICIES, IT WILL TRY TO RESIST THEM FOR THE REMAINDER OF THE AUTUMN AND UNTIL, AT LEAST, THE SPRING BUDGET. THERE ARE A NUMBER OF REASONS FOR THE GOVERNMENT TO TILT IN THIS DIRECTION:

A. THE MOST CREDIBLE DETERRENT TO OUTSIZE WAGE SETTLEMENTS IS THE LIKELIHOOD THAT THEY WILL RUN THE RISK OF LEADING TO BANKRUPTCY OF FIRMS AND ADDITIONAL UNEMPLOYMENT. THIS RISK IS THE GREATER THE MORE STRICTLY THE GOVERNMENT HOLDS TO THE LIMITS ON THE GOVERNMENT DEFICIT AND ON GROWTH OF THE MONEY SUPPLY, A FACT THAT IS RECOGNIZED BY UNION LEADERS AND LABOR MPS. THEY CAN BE EXPECTED TO DEMAND RELAXATION OF THE CURRENT LIMITS BUT SINCE THE GOVERNMENT'S LONGER TERM STRATEGY

AND THE CONTINUED SUPPORT OF THE LIBERAL PARTY BOTH DEPEND TO SOME EXTENT ON KEEPING THE LID ON AGGREGATE DEMAND, THE GOVERNMENT IS LIKELY TO HOLD OUT AGAINST PRESSURES FOR REFLATION AS LONG AS POSSIBLE.

B. THERE ARE ALSO STRONG PRESSURES FROM WITHIN THE TREASURY AND THE BANK OF ENGLAND - FOR CONTINUED RESTRICTIVE OR RESTRAINED DEMAND POLICY. THESE OFFICIALS WILL PRESS FOR MAINTAINING IMF CONDITIONALITY AND STAND BY ACCESS TO FUND RESOURCES EVEN IF DRAWINGS ARE NOT ACTUALLY MADE, BECAUSE THE CONCOMITANT WILL BE A CONTINUED EXTERNAL CONSTRAINT ON BRITISH DEMAND POLICY AND CONTINUED INTERNATIONAL CONFIDENCE IN THE POUND. WHEN THE TIME COMES THAT NORTH SEA BENEFITS ARE A VALID ARGUMENT FOR A REVISION OF BRITISH POLICY, THEY WILL ARGUE FOR CONTINUED RESTRAINT ON CONSUMPTION TO PERMIT USE OF NORTH SEA SURPLUSES FOR REDUCTION OF BRITAIN'S OFFICIAL EXTERNAL FOREIGN CURRENCY DEBT (OVER \$20 BILLION) AND TO FINANCE INVESTMENT. FOR THE MOMENT, CHANCELLOR OF THE EXCHEQUER HEALEY IS LIKELY TO SIDE WITH HIS OFFICIALS, BUT IT IS NOT YET CLEAR HOW LONG HE WILL BE ABLE TO CARRY THE MAJORITY OF THE CABINET WITH HIM. LIMITED OFFICIAL USE

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C. IN ANY EVENT, THE REALLY GREAT BENEFITS FROM THE NORTH SEA HAVE NOT YET STARTED ROLLING IN. THIS IS PARTICULARLY TRUE OF GOVERNMENT TAX REVENUES WHICH, BECAUSE OIL PRODUCING FIRMS ARE ALLOWED GENEROUS EXPENSE DEDUCTIONS AGAINST PETROLEUM REVENUE TAX, WILL NOT GAIN MUCH FROM THE NORTH SEA UNTIL LATE 1978 OR 1979. THE MAJOR BENEFITS WILL BE IN THE 1980'S. FOR THE NEXT YEAR, THESE REVENUES WILL NOT RELIEVE THE PRESSURE CREATED BY THE AGREEMENT WITH THE IMF TO LIMIT THE PUBLIC SECTOR BORROWING REQUIREMENT, AND THEY CANNOT LEGITIMATELY BE ADVANCED AS AN ARGUMENT FOR ALLOWING GOVERNMENT SPENDING TO GO UP, OR TAXATION TO BE REDUCED IN THE NEAR TERM.

D. POLITICALLY, THE GOVERNMENT, UNLESS IT IS FORCED

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LAB-04 SIL-01 L-03 H-01 PA-01 PRS-01 STRE-00  
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-----114154 301545Z /45

P R 301439Z AUG 77  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC PRIORITY 7778  
INFO TREASURY DEPT WASHDC PRIORITY  
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INTO IT BY SOME UNEXPECTED EVENT, HAS RULED OUT AN AUTUM  
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ELECTION. COME SPRING IT MAY BE A DIFFERENT STORY AND  
THE REGULAR ANNUAL BUDGET (PROBABLY IN MARCH) WOULD BE  
A "NORMAL" TIME TO AID THE PARTY'S CHANCES BY IMPROVING  
THE VOTER'S LOT. BY THEN, TOO, IT WILL BE MUCH CLEARER  
HOW THINGS ARE GOING ON THE WAGE/PRICE FRONT. WAGES MAY  
THEN BE RISING RAPIDLY BUT PRICES MAY BE GROWING AT A  
MORE MODERATE PACE (THOUGH EVENTUALLY WAGE INCREASE MAY  
PASS THROUGH TO PRICES). THE GOVERNMENT MIGHT WELL BE

TEMPTED TO GO TO THE VOTERS AT A MOMENT WHEN GROWTH IN  
REAL INCOMES MAKES ITS CHANCES BETTER THAN EARLIER OR  
LATER.

15. TO SUM UP, WHILE THE SITUATION IS DEVELOPING TOWARD  
A POINT AT WHICH THERE MIGHT BE A CHANGE IN BRITISH  
ECONOMIC POLICY, SO FAR DEVELOPMENTS ARE IN LINE WITH  
OUR PREVIOUS ASSESSMENTS AND, PERHAPS MORE IMPORTANT,  
AN IMMEDIATE SIGNIFICANT CHANGE SEEMS UNLIKELY (AL-  
THOUGH LIMITED MEASURES TO CREATE OR PRESERVE JOBS MAY  
BE TAKEN DURING THE NEXT FEW MONTHS). NEXT SPRING STILL  
SEEMS LIKE THE TIME WHEN BRITISH POLICY MAY MAKE A  
DEFINITE TURN AND ENTER A MORE EXPANSIONARY PHASE.

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## Message Attributes

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**Disposition Action:** RELEASED  
**Disposition Approved on Date:**  
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**Disposition Comment:** 25 YEAR REVIEW  
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**Review Content Flags:**  
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**TAGS:** EGEN, ECON, UK  
**To:** STATE USEEC MULTIPLE  
**Type:** TE  
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